JUNE 2001

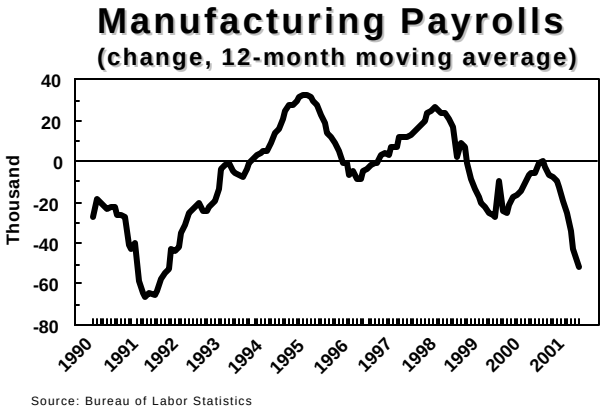
US OVERVIEW

At best, the second quarter of 2001 is the fourth straight quarter of slow economic growth. At worst, it is the first time the economy has dipped into negative growth since 1993. The unemployment rate, which tends to lag economic growth, is expected to rise in the months ahead. Watch consumer confidence and initial claims for unemployment insurance to gauge the future path of the jobless rate. Despite the economic slowdown, the productivity boom that started in 1996 is likely to continue. The recent decline in the productivity growth rate is no greater than what should be expected given the slowdown in the overall economy.

The Economy is Flat

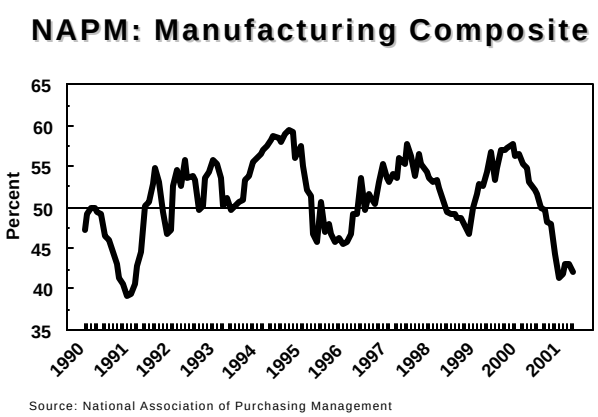
Aggregate work hours declined in April and were flat in May. Assuming hours are flat again in June – a reasonable assumption given that they've been flat since the economic slowdown started in mid-2000 – hours will have declined by an annual rate of 1.3% in the second quarter. A simple regression of hours on GDP growth suggests that fluctuations in hours explain about 70% of the variation in GDP growth (although less in recent years) and that a 1.3% drop in hours suggests a GDP growth rate of only 0.1% in the second quarter. An expanded model to predict GDP growth uses estimates of hours, personal consumption, construction, shipments of capital goods, and exports and actual values for changes in the stock market and inventories. The expanded model explains about 85% of the variation in quarterly GDP growth and predicts a drop in second quarter GDP of 0.1%.

Either way, using the simple hours only-based model or the expanded model, second quarter growth looks flat. This is consistent with the Federal Reserve's Beige Book released June 13, which reported "economic activity was little changed or decelerating in April and May."

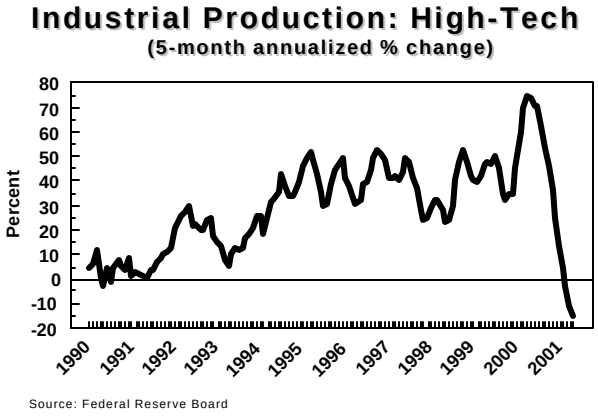


Source: Bureau of Labor Statistics

The manufacturing sector is bearing the burden of much of the slowdown, especially high-tech. Manufacturing has lost an average of 51,000 jobs per month in the past year, the National Association of Purchasing Managers' composite index is at levels last seen in the 1990-91 recession, and the utilization of manufacturing capacity has fallen faster and to lower levels than during that recession. Year-to-date, the production of computers, communications equipment, and semiconductors has fallen at about a 15% annual rate. What a reversal! High tech production increased at a 74% annual rate in the first five months of 2000. It's not all high-tech, though, dragging manufacturing down. Year-to-date, manufacturing production excluding high-tech has declined at a 6% annual rate.



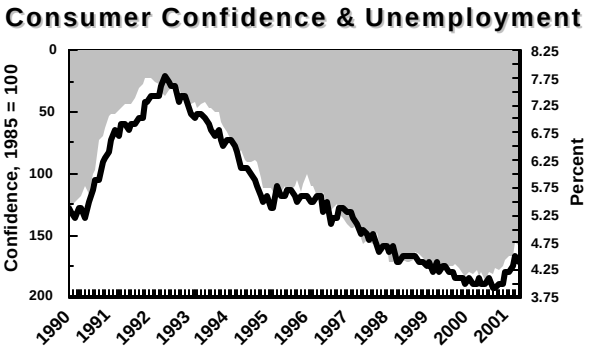
Source: National Association of Purchasing Management



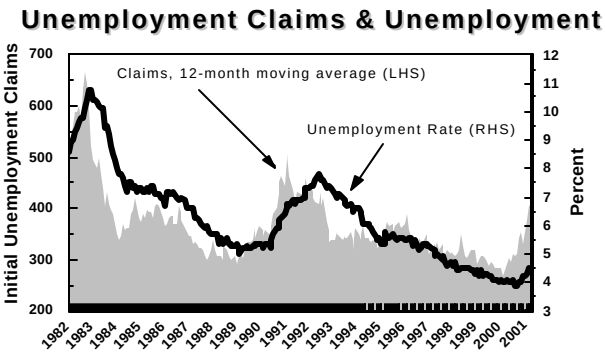
Source: Federal Reserve Board

Unemployment Is Rising

The unemployment rate fell to 4.4% in May, surprising most analysts who had expected it to stay at 4.5% or increase to 4.6%. Regardless, the unemployment rate is still up 0.5 percentage points in seven months (from 3.9% in October). Where is the unemployment rate heading from here? Watch consumer confidence and initial unemployment claims, which are giving conflicting signals right now. Unemployment tends to lag a couple of months behind consumer confidence, which has stabilized, suggesting joblessness may not rise as much as most analysts expect. On the other hand, the four-week moving average of initial claims for unemployment insurance has hit a



Source: The Conference Board, Bureau of Labor Statistics



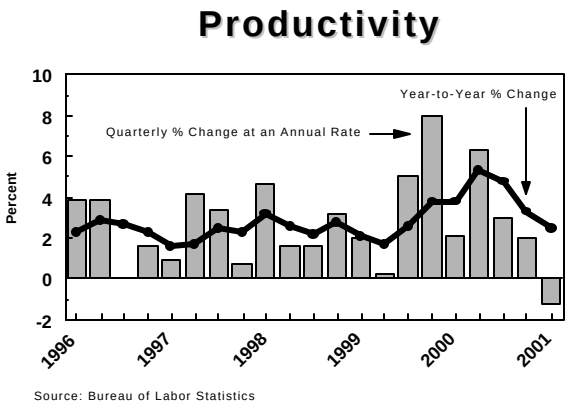
Source: The Conference Board, Bureau of Labor Statistics

post-1992 high, suggesting analysts' fears may be confirmed.

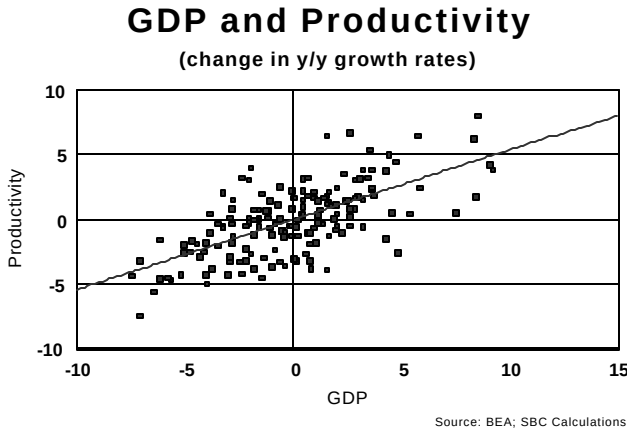
But the Productivity Boom is Not Dead

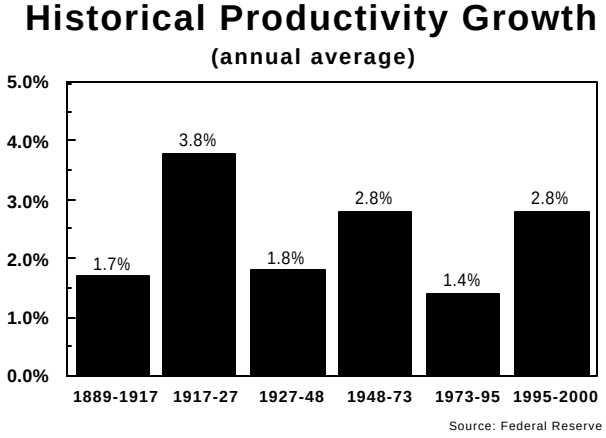
Ultimately, it is productivity growth that determines the sustainable rate of economic growth, income growth, and increases in living standards. Non-farm productivity growth averaged 2.9% per year from 1996 through 2000 making it the best five-year period since 1964 through 1968. The first quarter of 2001 brought different fortunes, however, with productivity falling at a 1.2% rate. The sudden drop in productivity renewed interest in whether the productivity boom of 1996-2000 was a temporary phenomenon or something more long-term.

The implications are enormous. With respect to federal finance, higher productivity means government spending will tend to shrink as a share of GDP and tax revenue will more easily allow for reductions in tax rates, overall reform of the income tax code, and a transition to a sustainable Social Security system. The productivity trend also has implications for near-term monetary policy. If the productivity boom is over, inflation is more likely to climb at any given level of real economic growth. In that environment, if the Fed eases monetary policy to try to get the growth rate back up to where it was during the productivity boom it will generate higher inflation. That kind of policy mistake could lead to a "W" pattern for economic growth, in which a short-term growth recovery next year is followed by another slowdown because the Fed has to ratchet rates upward to stamp out accelerating inflation.



So does the first quarter drop in productivity mean the productivity boom is over? No. The jury would need much more data before it rendered that kind of verdict. Productivity growth is a volatile statistic. During the current business cycle it has been about 75% more volatile than real GDP growth (as measured by the standard deviation divided by the mean). One quarter does not make a trend, either on the upside or the downside.





It is not unusual for productivity growth to decline or even go negative during economic slowdowns as businesses become less concerned about maximizing output per worker-hour. The US had negative productivity growth during the 1990-91 recession, the 1981-82 recession, part of the 1980 recession, and much of the 1973-75 recession. The last time the productivity growth rate was as high as 1996-2000 was 1964-1968 and that period included five quarters of negative productivity growth.

The above scatter chart shows *changes* in the productivity growth rate versus *changes* in the real GDP growth rate, both on a year-to-year basis, since 1960. For example, year-to-year GDP growth was 5.3% in Q1.2000 and 2.5% in Q1.2001, for a change of -2.8 percentage points. During the same time period, year-to-year productivity

growth declined from 3.8% to 2.5%, for a change of -1.3 percentage points. (Don't confuse this with the 1.2% drop in productivity in the first quarter, which was the annualized rate of decline in productivity in the first quarter versus the fourth quarter of 2000.) The regression line in the scatter plot suggests that given a 2.8 percentage point drop in the real GDP growth rate, productivity growth should have declined 1.5 percentage points, rather than the actual 1.3 point drop. In other words, productivity has dropped *less* than what would be expected given the pace of the economic slowdown. One possible explanation is that the underlying productivity trend is increasing even as the cyclical slowdown drags down productivity growth in the near term. Another possible explanation is that productivity may exhibit less cyclicality at higher trend rates of growth.

As Federal Reserve Governor Laurence Meyer pointed out in a recent speech, productivity growth tends to alternate between prolonged periods of robust growth and prolonged periods of sluggish growth, with each period lasting about 20 to 25 years. The US experienced strong productivity growth from the late 1940s through the early 1970s, followed by weak productivity growth until the mid-1990s. Based on the historical pattern, it would be highly unusual for the productivity boom that started in the mid-1990s to have ended in 2000, in only its fifth year.

Key Economic Indicators

Quarterly Indicators

(Q/Q, at annual rate)

	Q2-00	Q3-00	Q4-00	Q1-01
Real GDP Growth	5.6	2.2	1.0	1.3
Consumption	3.1	4.5	2.8	2.9
Business Investment	14.6	7.7	-0.1	2.1
Trade Deficit ($ bilions)	88.7	95.6	99.2	91.3
PCE Inflation	2.1	1.8	1.9	3.2
Productivity Growth	6.3	3.0	2.0	-1.2

Monthly Indicators

	Mar.	Apr.	May
Unemployment	4.3	4.5	4.4
Payroll Growth	59K	-182K	-19K
CPI Inflation (yr./yr.)	3.0	3.3	3.6
Retail Sales Growth (yr./yr.)	1.3	4.0	3.8
Corporate Rates (Baa)	7.8	8.1	8.1
Federal Funds Rate (Month End)	5.0	4.5	4.0
Dow (Month End)	9.9K	10.7K	10.9K